



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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August 23, 2002

Number: **200239028**
Release Date: 9/27/2002
UILC: 6203.00-00; 6651.00-00

CC:PA:APJP:B02
POSTF-150581-01

INTERNAL REVENUE SERVICE NATIONAL OFFICE
SIGNIFICANT SERVICE CENTER ADVICE

MEMORANDUM FOR: ASSOCIATE AREA COUNSEL - MIAMI
(SMALL BUSINESS/SELF-EMPLOYED)
CC:SB:3:MIA

FROM: Ashton P. Trice
Senior Technician Reviewer, Branch 2
(Administrative Provisions & Judicial Practice)
CC:PA:APJP:2

SUBJECT: Failure To Pay Penalty Upon Reversal of EITC

This Significant Service Center Advice responds to your memorandum dated May 17, 2002, which we received on June 18, 2002. In accordance with I.R.C. § 6110(k)(3), this Significant Service Center Advice should not be cited as precedent.

ISSUE

Upon the reversal of an Earned Income Tax Credit (EITC) as the result of an examination of a return, as of what date should the Internal Revenue Service (IRS) assess a failure to pay addition to tax?

CONCLUSION

Liability for a failure to pay addition to tax arising from reversal of an EITC claim cannot arise until after the Service has assessed the deficiency arising from the disallowance of the EITC, made notice and demand for payment, and 21 days have elapsed without payment. After these events, the addition to tax would accrue at the rate of 0.5 percent per month of the amount of tax which remains unpaid, until the addition to tax reaches a maximum of 25 percent in the aggregate. Once the liability for the failure to pay begins to accrue, it may be assessed up to the amount accrued at the time of assessment. The assessment occurs as of the date that the assessment officer signs the summary record of assessment reflecting a taxpayer's liability for the failure to pay addition to tax and the Service's records of assessment should reflect that assessment date.

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FACTS

A taxpayer's return claiming an EITC is examined. The Service proposes to disallow an EITC claim in whole or in part, which creates a deficiency. After a statutory notice of deficiency is issued and the taxpayer defaults or petitions and loses in Tax Court, Service Centers assess the deficiency and record the assessment with a Transaction Code 300. Sometimes, however, Service Centers are separately showing the reclaiming of part or all of the EITC as a reversal as of the date of filing of the original return. As a result, a failure to pay addition to tax is sometimes calculated from the return due date, *i.e.*, the date payment was due. In addition, Service records sometimes reflect that a failure to pay addition to tax on the recouped EITC was assessed on the date of the original return.

ANALYSIS

Failure to Pay Additions to Tax

There are two different types of failure to pay additions to tax contained in section 6651 of the Code: subsections 6651(a)(2) and 6651(a)(3). The addition to tax under section 6651(a)(2) applies to a taxpayer who reports an amount of tax due on his return but fails to pay it by the payment due date. The addition to tax is 0.5 percent per month of the amount of tax shown on the return, but unpaid, for each month that payment is overdue, until the addition to tax reaches a maximum of 25 percent. The addition to tax under section 6651(a)(3) applies upon the failure to pay any amount in respect of any tax required to be shown on a return, which is not so shown, within 21 calendar days from the date of notice and demand therefor (10 business days if the amount for which notice and demand is made equals or exceeds \$100,000). The addition to tax under section 6651(a)(3) is 0.5 percent of the amount of tax stated in the notice and demand for each month that the failure to pay continues. Like the section 6651(a)(2) addition to tax, the addition under section 6651(a)(3) may not exceed 25 percent. Note that a section 6651(a)(2) addition to tax is calculated from the payment due date, which is generally the same as the due date for filing the return without regard to extensions of time for filing. See I.R.C. § 6151(a). In contrast, no section 6651(a)(3) addition to tax can be owed for the period that precedes 21 calendar days after notice and demand for payment of tax is made (10 business days for amounts at or above \$100,000).

The section 6651(a)(2) addition to tax cannot arise by reason of a reversal of an EITC claim. As stated above, the (a)(2) addition to tax arises only upon the failure to pay the amount shown as tax on a return. A reversal of an EITC claim does not change the amount shown as tax on a return.

We reach the conclusion that reversal of an EITC claim does not change the amount shown as tax on a return by reference to the definition of a deficiency. Section 6211(a) defines a deficiency as the amount of tax imposed that exceeds the amount of tax

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shown on the return. Therefore, if there is a deficiency on a taxpayer's return, the amount of the deficiency is an adjustment to the amount of tax shown on the return. The EITC, a credit under section 32 of the Code, is specifically included as part of the calculation of a deficiency and cannot be reversed without following deficiency procedures. I.R.C. § 6211(b)(4). Thus, an adjustment to an EITC is, by definition, an adjustment to the amount of tax shown on the return. When an amount of tax owed (i.e., a deficiency) is the result of an adjustment to the amount of tax shown on the return, it cannot be included in the calculation of the addition to tax under section 6651(a)(2). Because, for purposes of section 6211(a)(1), the EITC affects the amount of tax shown on the return, adjustments to the EITC cannot trigger the section 6651(a)(2) addition to tax.

Conversely, an addition to tax under section 6651(a)(3) can arise from the failure to pay an assessment relating to reversal of an EITC. If the Service determines that an EITC claim should be reversed in whole or part, it must issue a statutory notice of deficiency which can be assessed upon a taxpayer's default in responding to the notice or upon a favorable, final decision by the Tax Court. Upon assessment, the Service will issue notice and demand for payment which, if unpaid for more than 21 days, will result in liability for a section 6651(a)(3) addition to tax arising and continuing to accrue until the taxpayer pays in full or the addition to tax reaches its maximum.

Assessment of Section 6651(a)(3) Addition to Tax

An assessment under the Internal Revenue Code is essentially a bookkeeping entry made to record a taxpayer's liability. I.R.C. § 6203; Treas. Reg. § 301.6203-1; Laing v. United States, 423 U.S. 161, 170 n.13 (1976). "The assessment shall be made by an assessment officer signing the summary record of assessment." Treas. Reg. § 301.6203-1. Because liability for the failure to pay addition to tax under section 6651(a)(3) does not arise until the twenty-second day after the Service makes notice and demand for payment of the assessment of a reversed EITC, assessment of the addition to tax cannot properly occur before that date, much less the date the original return claiming the EITC is filed. "The date of assessment is the date the summary record is signed by an assessment officer." Treas. Reg. § 301.6203-1. Service records should reflect that actual date of assessment.¹ Moreover, as noted above, the Service should be sure to calculate the section 6651(a)(3) addition to tax only from the twenty-

¹ Note that at least one case has recognized that assessment of the section 6651(a)(3) addition to tax need not be made within the three-year period prescribed by section 6501(a). In United States v. Krasnow, 548 F. Supp. 686 (S.D.N.Y. 1982), the court recognized that requiring assessment of the addition within three years of the filing of a taxpayer's return would preclude the addition from ever being able to reach its statutory maximum and would frustrate the underlying congressional purposes of passing section 6651(a)(3).

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second calendar day (eleventh business day for \$100,000 or more) after making notice and demand for payment, and not to calculate the addition to tax from the due date of the return.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. If you have questions, please contact (202) 622-4940.